SINGLE ARTICLE REPRINT AS SEEN IN THE JUNE 2017 ISSUE OF THE NAPFA ADVISOR

Infrastructure-related opportunities for municipal bond investors

BY DUANE MCALLISTER

Accomplishing big things typically requires the collaboration of many. Throughout our nation's history, significant societal advances, whether in the areas of science, medicine, technology, education, business, or human rights, have all involved the cooperation of many different talented and committed participants. Building the infrastructure of our country has been no exception. Municipal debt has provided funding for infrastructure projects since the early 1800s. Municipal bonds were used to fund the construction of the Erie Canal, which opened in 1825. Later, bonds were used again to expand the canal.

Looking around the country today, it's easy to see why President Trump has made repairing and rebuilding the nation's infrastructure a priority. The American Society of Civil Engineers (ASCE) recently completed a comprehensive assessment of the nation's infrastructure and once again assigned a grade of D+. Its report identified a $2 trillion funding gap over the next 10 years that will need to be filled to provide the needed repairs and upgrades. ASCE concluded that "we must increase investment from all levels of government and the private sector."

ASCE refers to both government and the private sector as sources of infrastructure investment. For the government side of spending, individuals may have the opportunity to participate in infrastructure investment through purchasing municipal bonds or investment vehicles that purchase municipal debt. The interest on these bonds is typically tax-exempt because the projects they finance serve a broad public purpose and have high credit quality. Municipal debt can also be issued as taxable securities if the project primarily benefits private entities, opening the door for all investors to participate regardless of whether they pay income taxes as individuals.

A role for munis, both tax-exempt and taxable

The municipal bond market will be important in infrastructure financing. Three quarters of all infrastructure spending in the U.S. occurs at the state and local level. General obligation municipal debt provides money for schools and other municipal needs, such as local roads and bridges. Municipal debt provides financing for water and sewer systems, universities, healthcare facilities, and much more, all backed by a dedicated revenue stream. Other municipal borrowings provide funds for airport and mass transit needs that provide benefits for entire regions of the country.

The projects the municipal market finances are as varied as the communities in which we live. Fortunately, there is capacity to do more.

Currently, 90 percent of municipal debt is tax-exempt, where investor demand is strong. But even greater capacity exists in the taxable municipal market because it appeals to both individual and institutional investors, domestic as well as international. Taxable municipals are another sector for investors to consider alongside the market's more broadly held government, corporate, and mortgage-backed sectors.

Even if corporate and personal tax rates are reduced, as has been proposed, municipal debt is very likely to remain a core fixed income asset.

The ability for investors to absorb significant additional municipal debt was demonstrated by their response to the Build America Bond (BAB) program, in which municipal bonds were issued as taxable securities. Unlike other taxable munis, BABs were issued as taxable securities because the government agreed to provide federal subsidies for state and local government bond issuers. The goal of

Continued on next page

Continued from previous page

these subsidies was to lower issuers' borrowing costs to help stimulate borrowing and growth in the economy.

More than $180 billion of taxable municipal debt was issued over the 21 months from April 2009 to December 2010 when the BAB program was active. The $180 billion in BAB issuance over that short period amounted to nearly 20 percent of the $1 trillion that President Trump has proposed to spend on infrastructure over the next 10 years. We believe that the Trump administration may look to increase issuance in both the tax-exempt and taxable municipal markets to provide infrastructure financing, and may even consider reviving the BAB program.

Tax reform and monetary policy normalization are two other developments that may affect municipal bonds as they unfold along with President Trump's infrastructure plan. While a broad outline of President Trump's tax reform plan has been released, many details remain unknown, and it remains uncertain how potential tax policy changes might affect the municipal market. Yet, given the importance of municipal debt historically in financing state and local projects, eliminating its tax exemption seems both counterintuitive and unlikely. Even if corporate and personal tax rates are reduced, as has been proposed, municipal debt is very likely to remain a core fixed income asset.

Individual investors, who remain the dominant player in the tax-exempt municipal market, will continue to benefit from the tax exemption, regardless of the top marginal income tax rate. Institutions, which currently control the majority of taxable municipal debt, will welcome the opportunity to invest in the high quality municipal market as a means of diversifying their fixed income holdings. Should policy changes occur, valuation adjustments between taxable and tax-exempt debt may shift, but the financial strength of the municipal credits will not. More than half of rated municipal debt is rated AA or higher, and defaults have been rare.

Strategy for investing in munis

Investors who are concerned about the impact of potential tax changes may want to focus their investments on the shorter end of the yield curve, where shorter-duration bonds would experience less price fluctuation should marginal tax rates be lowered and prices decline. Longer-term municipal debt is subject to greater price volatility from both interest rate changes and tax rate changes. Aligning your duration exposure with your unique tolerance for risk is always a prudent strategy in the fixed income markets.

The same yield curve exposure strategy applies to concerns over changes in the federal funds rate. Further increases in the fed funds rate are expected as the Fed continues on its path toward policy normalization. How future rate increases will affect market rates across the yield curve is uncertain. However, once again, maintaining a shorter average maturity should help insulate portfolios from significant price fluctuations.

The opportunities to invest in America are likely to be plentiful over the next several years. While interest rates remain low by historical standards, investors must also balance risk and reward when investing. Investors who seek a lower-risk way to help rebuild the nation's infrastructure are likely to earn a return in the municipal market that's competitive with other fixed income sectors. They may do even better if they are able to fully capitalize on the tax advantages available on tax-exempt issues.

An efficient way for individual investors to gain exposure to the municipal market is through mutual funds that invest in the municipal sector. Tax-exempt mutual fund options are abundant, as are taxable fixed income funds that allocate a portion of their assets to taxable municipals. The broad diversification and liquidity of funds provides a way for investors of all sizes and income levels to invest in America.

Whether the infrastructure borrowing occurs in the taxable or tax-exempt municipal market is less important than individual investors understanding the important role they can play in helping to repair and rebuild our nation's infrastructure. It's a win for investors and a win for the nation.

We await further details on an infrastructure plan from the Trump administration in coming months. When a plan is put in place we will analyze it carefully for the investment opportunities it creates.

Duane McAllister is managing director and senior portfolio manager, Baird Advisors.